

Message Text

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PAGE 01 SEOUL 05294 01 OF 02 250439Z

ACTION PM-04

INFO OCT-01 EA-07 ISO-00 AID-05 DODE-00 EB-07 IGA-02

NSC-05 SP-02 SS-15 L-03 H-01 CIAE-00 INR-07

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R 250337Z JUN 77

FM AMEMBASSY SEOUL

TO SECSTATE WASHDC 4732

LIMITED OFFICIAL USE SECTION 1 OF 2 SEOUL 5294

ALSO FOR AID

E.O. 11652: N/A

TAGS: MASS, MPOL, EAID, KS

SUBJECT AID IMPLEMENTATION OF PRESIDENT'S ARMS TRANSFER POLICY

REF: (A) STATE 122750; (B) STATE 126580; (C) AIDTO CIRC-A

222 OF JUNE 4, 1977

SUMMARY:: ALTHOUGH FUTURE MILITARY SPENDING IS PRESENTLY UNDERGOING REVIEW IN LIGHT OF THE U.S. POLICY TO REDUCE ITS FORCES IN KOREA, PAST PERFORMANCE INDICATES THAT MILITARY SPENDING HAS NOT CUT INTO KOREA'S ECONOMIC GROWTH TO ANY SIGNIFICANT EXTENT OR EXACERBATED BALANCE OF PAYMENTS PROBLEMS. SINCE 1970, DESPITE UNDERTAKING A MUCH GREATER SHARE OF ITS OWN DEFENSE BURDEN AND INCREASING MILITARY IMPORTS BY A FACTOR OF 50, KOREAN REAL GNP HAS GROWN AT AN AVERAGE RATE OF 10.4 PERCENT PER YEAR AND FOREIGN EXCHANGE RESERVES HAVE MULTIPLIED ALMOST SEVENFOLD. IF, AS THEY HAVE INDICATED THEY WILL, THE KOREANS RESTRICT DEFENSE SPENDING TO 7 PERCENT OR LESS OF GNP, THERE SHOULD BE NO DIFFICULTY IN HAVING BOTH GUNS AND SOME BUTTER. THE ONE POTENTIAL PITFALL IS BORROWING FOR MILITARY IMPORTS AT LEVELS THAT WOULD DISRUPT DOMESTIC PRIORITIES. END SUMMARY.

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PAGE 02 SEOUL 05294 01 OF 02 250439Z

1. RECENTLY ANNOUNCED U.S. POLICY TO REDUCE THE U.S. MILITARY PRESENCE IN KOREA HAS OCCASIONED A RE-EVALUATION OF KOREAN MILITARY PLANNING, WHICH IS PRESENTLY UNDERWAY. UNTIL COMPLETED, IT IS NOT POSSIBLE TO MAKE ACCURATE PROJECTIONS OF FUTURE KOREAN DEFENSE EXPENDITURES. U.S. ASSISTANCE LEVELS, ALSO NOT YET DETERMINED, WILL BE A

MAJOR FACOTR INDETERMINING THE IMPACT OF THOSE EXPENDITURES.

2. BEFORE ITS PHASE-OUT IN 1976, U.S. MILITARY GRANT AID SUPPLIED A LARGE SHRE OF KOREA'S BASIC MILITARY IMPORTS. KOREAN INDUSTRY CAN NOW MEET MANY BASIC REQUIREMENTS SUCH AS SMALL ARMS, AMMUNITION AND SOME ARTILLER. SINCE 1970 THE KOREANS HAVE UNDERTAKEN AN INCREASING SHARE OF THEIR DEFENSE EFFORT, FROM 50.9 PER CENT TO 99.5 PERCENT BY 1976. WHAT THIS HAS MEANT FOR DEFENSE SPENDING IS ILLUSTRATED BY THE FOLLOWING PERCENTAGES:

	1970	1977 (ESTIMATED)
BUDGET/GNP	17.0	19.3
MILITARY SPENDING/GNP	4.0	6.5
MILITARY SPENDING/BUDGET	23.2	34.1
MILITARY IMPORTS/IMPORTS	0.45	5.6
MILITARY IMPORTS/EXPORTS	1.1	5.8

3. DURING THE SAME PERIOD THE KOREAN ECONOMY SHOWED STRONG GROWTH. INDICATORS OF THAT GROWTH ARE:

	1970	1977 (ESTIMATED)
AVERAGE GROWTH GNP		10.4 PERCENT
PER CAPITA GNP	\$234	\$853
POPULATION GROWTH RATE	2.18	1.61

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PAGE 03 SEOUL 05294 01 OF 02 250439Z

EMPLOYED PERSONS	9,745,000	13,093,000
UNEMPLOYMENT RATE	4.5	3.9 PERCENT

4. ON THE BASIS OF THE ABOVE DATA IT WOULD APPEAR THAT PAST INCREASES IN MILITARY EXPENDITURES HAVE NOT DISRUPTED KOREA'S ECONOMIC DEVELOPMENT TO ANY SIGNIFICANT EXTENT. A ROUGH ESTIMATE WOULD BE THAT IT HAS REDUCED ANNUAL AVERAGE GROWTH BY LESS THAN 0.5 PERCENT.

5. NOR IS THERE EVIDENCE THAT, TO NOW, DEFENSE IMPORTS HAVE CAUSED SERIOUS BALANCE OF PAYMENTS PROBLEMS. IN THE PERIOD 1970 TO 1976, FOREIGN DEBT INCREASED FROM \$1,840 MILLION TO \$7,160 MILLION. TOTAL DEFENSE IMPORTS THROUGH 1976 (INCLUDING REPAYMENT OF LOANS) WERE 11.1 PERCENT OF THE TOTAL DEBT. FMS CREDITS, KOREA'S PRINCIPAL BORROWING SPECIFICALLY FOR MILITARY PURCHASES, WERE \$279.9 MILLION, AND, NET OF REPAYMENTS, ONLY 3 PERCENT OF TOTAL DEBT. FURTHERMORE, BECAUSE OF THE GROWTH OF THE KOREAN ECONOMY AND FOREIGN EXCHANGE EARNINGS, THE DEBT SERVICE RATIO DECLINED FROM 21 PERCENT IN 1970 TO 10.8 PERCENT IN 1976. IT IS EXPECTED TO RISE ONLY SLIGHTLY IN 1977 TO 11.2 PERCENT. FOREIGN EXCHANGE RESERVES INCREASED FROM \$583.5 MILLION

IN 1970 TO \$2,960 MILLION IN 1976, AND ARE EXPECTED TO GROW TO \$4,000 MILLION BY THE END OF 1977.

6. KOREA MAINTAINS A STANDING FORCE OF ROUGHLY 600,000 (1.6 PERCENT OF TOTAL POPULATION). THIS IS 4.4 PERCENT OF THE LABOR FORCE AS DEFINED BY THE KOREAN GOVERNMENT. ALTHOUGH THE ECONOMY HAS BEEN ABLE TO CREATE JOBS AT A FASTER RATE THAN WORKERS HAVE BEEN ENTERING THE MARKET, WITHOUT THE MILITARY FORCES THE UNEMPLOYMENT RATE WOULD UNDOUBTEDLY BE HIGHER. IT WOULD NOT BE POSSIBLE TO SAY PRECISELY HOW MUCH HIGHER BECAUSE MANY NOW IN MILITARY SERVICE WOULD BE MEMBERS OF RURAL HOUSEHOLDS, AND, ALTHOUGH PERHAPS UNDEREMPLOYED, WOULD BE CONSIDERED TO BE EMPLOYED.

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PAGE 04 SEOUL 05294 01 OF 02 250439Z

7. ONE BENEFIT THE ECONOMY HAS RECEIVED FROM THE MILITARY SERVICE PROGRAM IS AN INCREASE IN SEMI-SKILLED AND SKILLED MANPOWER AS A RESULT OF THE TRAINING RECEIVED BY MILITARY PERSONNEL. EVEN THE RELATIVELY UNSKILLED COMBAT SOLDIERS, ESPECIALLY FROM RURAL AREAS, HAVE GAINED EXPERIENCE IN DEALING WITH MODERN TECHNOLOGY AND ORGANIZATIONS THROUGH MILITARY SERVICE.

8. IN 1975, THE KOREAN GOVERNMENT INSTITUTED A DEFENSE SURTAX AS A MEANS OF FINANCING THE MODERNIZATION OF ITS FORCES. DEFENSE TAX COLLECTIONS ARE USED ENTIRELY FOR DEFENSE IMPORTS. IN 1976 THE FENSE SURTAX AMOUNTED TO 2.2 PERCENT OF GNP AND 11.7 PERCENT OF TOTAL TAXES. IN 1977 THE RATIOS ARE EXPECTED TO BE 2.1 PERCENT AND 10.7 PERCENT, RESPECTIVELY. THE DEFENSE SURTAX IS APPLIED TO ALMOST ALL TAXES IN KOREA, THE NOTABLE EXCEPTION BEING THE BUSINESS TAX. IT WILL BE CONTINUED WHEN THE VALUE ADDED TAX GOES INTO EFFECT JULY 1, 1977.

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PAGE 01 SEOUL 05294 02 OF 02 250429Z
ACTION PM-04

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FM AMEMBASSY SEOUL

TO SECSTATE WASHDC 4733

LIMITED OFFICIAL USE SECTION 2 OF 2 SEOUL 5294

ALSO FOR AID

E.O. 11652: N/A

TAGS: MASS, MPOL, EAID, KS

SUBJECT: AID IMPLEMENTATION OF PRESIDENT'S ARMS TRANSFER POLICY

9. AFTER ONLY ONE FULL YEAR OF EXPERIENCE, IT WOULD BE DIFFICULT TO DRAW EXACT CONCLUSIONS: BUT THERE IS NO QUESTION THAT THE DEFENSE SURTAX INCREASES THE TAX BURDEN, 19 PERCENT IN 1977, AND THEREBY REDUCES DISPOSABLE INCOME. TO DATE IT WOULD APPEAR THAT ITS IMPACT HAS BEEN MORE ON CONSUMPTION THAN ON SAVINGS. IN 1976 PRIVATE AND GOVERNMENT CONSUMPTION AS A PERCENTAGE OF CONSTANT PRICE GNP DECLINED TO 70.3 PERCENT FROM 74.9 PERCENT IN 1975. AT CURRENT MARKET PRICES, THE DROP WAS FROM 82.0 PERCENT TO 78.6 PERCENT. HOW MUCH OF THE DECLINE WAS DUE TO THE DEFENSE TAX WOULD BE DIFFICULT TO SAY; HOWEVER, GOVERNMENT CONSUMPTION SHOWED ONLY A SMALL RISE AS A PROPORTION OF GNP IN 1976 WHILE THE PRIVATE SAVINGS RATIO INCREASED FROM 12.4 PERCENT IN 1975 TO 16.4 PERCENT. IN CONSTANT PRICES, PRIVATE CONSUMPTION EXPENDITURES ARE AT 60 PERCENT OF GNP (65.7 PERCENT IN CURRENT PRICES); CONSEQUENTLY, THE MARGINS FOR FURTHER CUTBACKS ARE BECOMING SMALLER.

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PAGE 02 SEOUL 05294 02 OF 02 250429Z

10. THE KOREAN GOVERNMENT HAS INDICATED THAT IT INTENDS TO HOLD DEFENSE EXPENDITURES TO 7 PERCENT OF GNP. IF NOTHING AS ADVERSE AS THE DISRUPTIONS OF 1973-74 OCCUR, THERE SHOULD BE NO DIFFICULTY MEETING THAT CEILING AND STILL HAVING SUFFICIENT RESOURCES TO MAINTAIN HIGH LEVELS OF ECONOMIC GROWTH. FOR EXAMPLE, IN 1977, ON THE BASIS OF AVAILABLE DATA, IT WOULD SEEM THAT THE TARGET OF \$10 BILLION IN EXPORTS (32.4 PERCENT OF GNP) WILL BE ACHIEVED AND THE TARGET OF 10 PERCENT REAL GNP GROWTH MAY BE SLIGHTLY SURPASSED. THERE IS ALSO SOME EVIDENCE THAT THE BALANCE OF PAYMENTS PICTURE MAY BE BRIGHTER THAN ORIGINALLY FORECAST. ALREADY SOME AUTHORITIES EXPECT THE ANTICIPATED DEFICIT IN THE CURRENT ACCOUNT OF \$484 MILLION MIGHT IN FACT BECOME A SMALL SURPLUS.

11. INCREASED FOREIGN BORROWINGS TO FINANCE DEFENSE IMPORTS,

HOWEVER, HAVE POTENTIAL TO BECOME A PROBLEM FOR KOREA. AT PRESENT, RISING EXPORTS AND FOREIGN EXCHANGE RESERVES, AS WELL AS THE PROSPECT THAT PREVAILING INTERNATIONAL TRADE CONDITIONS WILL CONTINUE, PROVIDE THE ABILITY TO RAISE DEFENSE IMPORTS WITHOUT NECESSITATING A CUTBACK OF FOREIGN LOANS FOR ECONOMIC DEVELOPMENT. IF LARGE BORROWINGS FOR MILITARY PURPOSES CAUSED THE DEBT SERVICE RATIO TO CLIMB SIGNIFICANTLY TO HIGHER LEVELS, IT MAY HAVE AN ADVERSE PSYCHOLOGICAL EFFECT ON KOREA'S CREDITORS, ESPECIALLY FOREIGN BANKERS BOTH U.S. AND EEC. AS A RESULT, LOANS MIGHT BECOME LESS AVAILABLE OR AT MORE ONEROUS TERMS RESULTING IN DISLOCATIONS IN OTHER SECTORS OF THE ECONOMY. A CONCOMITANT COULD BE THAT, IN THE EVENT THE WORLD ECONOMY PLUNGED, KOREA MAY BE LEFT WITH LITTLE MARGIN OF CREDIT TO CALL UPON TO PROVIDE B.O.P. ASSISTANCE SUCH AS THAT WHICH ENABLED THE COUNTRY TO CONTINUE GROWING DURING THE DIFFICULT 1974-75 PERIOD. FORTUNATELY, GIVEN THE PRESENT OUTLOOK, THE LIKELIHOOD LIMITED OFFICIAL USE

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PAGE 03 SEOUL 05294 02 OF 02 250429Z

OF A "BORROWING CRISIS" APPEARS REMOTE.

12. WE NOTE FROM REF C THAT AID/W MAY NOT HAVE THE LATEST DATA COVERING KOREAN MILITARY SPENDING. WE ARE FORWARDING BY POUCH THE LATEST DATA AVAILABLE TO US. SNEIDER

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